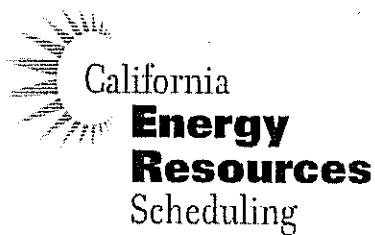


# **Department of Water Resources Electric Power Fund Financial Statements**

March 31, 2003



Department of  
Water Resources

# Department of Water Resources Electric Power Fund

## Table of Contents

---

### Page

Management's Discussion and Analysis .....	1
Statements of Net Assets .....	7
Statements of Activities .....	8
Statements of Cash Flows .....	9
Notes to Financial Statements .....	10

**Department of Water Resources Electric Power Fund**  
**Management's Discussion and Analysis**  
**As of and for the period ended March 31, 2003**

---

**USING THIS REPORT**

This financial report consists of three financial statements with accompanying notes for the Department of Water Resources Electric Power Fund (Fund), which is administered by the California Department of Water Resources (DWR). The Statements of Net Assets, prepared on the accrual basis of accounting, includes all assets and liabilities of the Fund. The Statements of Activities, also prepared on the accrual basis, take into account all revenues and expenses for the Fund regardless of when cash is received or paid. The Statements of Cash Flow reflect the actual cash receipts and disbursements for a specified period of time. This report should be read in conjunction with the Fund's June 30, 2002, audited financial statements. The Statements of Activities cover the three and nine-month periods ended March 31, 2003 and 2002. The Statements of Cash Flows cover the nine-month periods ended March 31, 2003 and 2002.

**HISTORY AND INITIAL FINANCING**

The Fund was established in January 2001, in connection with the Governor of California's emergency proclamation and subsequent legislation to assist in mitigating the effects of a statewide energy supply emergency. The enabling legislation included the following powers and requirements:

- Authorization to secure and requirement to retain title to power for resale to end use customers of the State's investor owned utilities (IOUs).
- Authorization to enter into servicing arrangements with the IOUs for transmission, distribution, billing and collection services.
- Entitlement to recover revenue requirements for authorized activities, including but not limited to debt service, the costs of power purchases, administrative costs and reserves.
- Authorization to enter into agreements with California Public Utility Commission (CPUC) to ensure collection of DWR's revenue requirements.
- Restriction from entering into new power supply contracts after December 31, 2002.
- Authorization to administer existing power supply contracts after December 31, 2002.
- Authorization to issue revenue bonds not to exceed \$13.4 billion.

Through June 26, 2001, funding for these activities came from advances from the State's General Fund as permitted by the enabling legislation. As of June 30, 2002, advances aggregating \$6.1 billion were outstanding with the proceeds of the advances having been used to make payments for purchased power.

On June 26, 2001, additional funding was provided from the net proceeds of a \$4.3 billion term loan from a financial consortium led by JPMorgan Chase Bank. As of June 30, 2002, the outstanding balance on the term loan was \$3.8 billion.

**SALE OF REVENUE BONDS**

In November 2002, DWR completed the issuance of \$11.3 billion in revenue bonds. All bonds other than Series E are tax-exempt bonds.

**Department of Water Resources Electric Power Fund**  
**Management's Discussion and Analysis**  
**As of and for the period ended March 31, 2003**

---

A table summarizing the bond issue by series follows:

Series	Rates	Fiscal Year of Final Maturity	Par Value (in millions)
A	3 - 6%	2022	\$ 6,314
B	Variable	2020	1,000
C	Variable	2022	2,750
D	Variable	2022	500
E	3.6-4.3%	2006	700
			<u>\$ 11,264</u>

The initial interest rate for the variable rate bonds was set at 1.8% and was in place until mid-January 2003. At that time the Series B and C bonds converted to daily and weekly rate resets, respectively, and Series D converted to 35-day auction periods. Interest rates on the variable rate bonds for the three month period ended March 31, 2003 ranged from 0.75% to 1.80%.

DWR also entered into \$1.4 billion notional amount of forward interest rate swaps, reducing its unhedged variable rate exposure to approximately 25% of the initial par value of the bonds outstanding. The interest rate swaps became effective in February 2003.

The proceeds of the bonds, along with the \$2.1 billion Fund cash balance at the time of the bond issuance, were used to repay the term loan, repay advances from the State's General Fund, and establish separate accounts in the Fund as required by the Bond Indenture. The revenue bonds are payable from Bond Charges and, if necessary, other revenues, collected over a 20 year period. The primary cash and investment accounts established by the Bond Indenture, their purpose and their source of revenue are identified below:

**Bond Charge Accounts:**

- **Bond Charge Collection Account:** Bond Charges are specific charges to IOU customers on all power (including DWR and IOU power) delivered to such customers and are used for repayment of debt service and other debt related costs. Bond Charges are deposited into the Bond Charge Collection Account. Monthly, funds needed to make debt service payments or set-asides are transferred to the Bond Charge Payment Account.
- **Bond Charge Payment Account:** Monies in the Bond Charge Payment Account are used to pay debt service, swap payments and related fees for the revenue bonds. After receipt of the monthly transfer from the Bond Charge Collection Account, the Bond Charge Payment Account must have a balance at least equal to the debt service, swap payments and fees estimated to accrue or be payable for the next succeeding three months.
- **Debt Service Reserve Account:** The account must maintain a balance equal to the amount of maximum aggregate annual debt service on all outstanding debt.

**Department of Water Resources Electric Power Fund**  
**Management's Discussion and Analysis**  
**As of and for the period ended March 31, 2003**

---

Power Charge Accounts:

- Operating Account: Power Charges are charges to IOU customers for all DWR power purchased by the Fund for the benefit of the customers. Power Charges and miscellaneous revenue are deposited into this account. Monthly, funds are transferred to the Priority Contract Account as needed to make payments on Priority Contracts. Remaining monies are available for payment of costs of the Fund other than Priority Contracts, debt service and debt related costs.
- Priority Contract Account: Priority Contracts are those long-term contracts that are required to be paid prior to any debt service. Monies in the Priority Contract Account are used to make scheduled payments on Priority Contracts. After the monthly transfer from the Operating Account on the fifth of the month, the Priority Contract Account has monies to make scheduled payments on Priority Contracts through the fifth of the following month.
- Operating Reserve Account: The account is to be funded at all times with an amount equal to that derived by formula based on the greater of (i) seven months of projected negative operating cash flows under a stress scenario, or (ii) a specified percentage of projected expenses of the Fund.

TRANSITION OF RESPONSIBILITIES EFFECTIVE JANUARY 1, 2003

Effective January 1, 2003, DWR transferred certain power procurement responsibilities to the IOUs. DWR no longer purchases power, except power provided under the terms of its existing contracts. DWR also transferred the scheduling, dispatch, and certain other administrative functions for the existing contracts to the IOUs; however, DWR retains the legal and financial responsibility for the existing contracts until such time as there is complete assignment of the contracts and release of DWR.

Before DWR transferred certain power procurement responsibilities to the IOUs on January 1, 2003, DWR was required under the terms of the Bond Indenture for the revenue bonds to maintain a minimum Operating Account balance of \$1 billion. Under the terms of the Bond Indenture, DWR may now reduce the minimum Operating Account balance to the maximum amount projected by DWR by which operating expenditures may exceed Power Charges during any one calendar month, taking into account a range of possible future outcomes that DWR deems to be appropriate.

Before DWR transferred certain power procurement responsibilities to the IOUs on January 1, 2003, DWR was also required to maintain the Operating Reserve Account balance at the greater of (i) seven months of projected negative operating cash flows, taking into account a range of possible future outcomes that DWR deems to be appropriate, or (ii) 18% of projected annual operating expenses of the Fund. Under the terms of the Bond Indenture, now that DWR is only providing power under the terms of its long-term contracts, the second test is 12% of projected annual operating expenses of the Fund.

Based on the changes in its operating responsibilities and requirements, and as permitted by the Bond Indenture, DWR is currently evaluating to what extent it will reduce the minimum Operating Account and Operating Reserve Account balances. The final decision concerning any reductions will be made in conjunction with the establishment of a 2003 Supplemental Revenue Requirement currently being developed by DWR. Upon completion of internal analyses, which includes analyzing actual results through March 31, 2003, and consultation with the CPUC and others, a preliminary 2003 Supplemental

**Department of Water Resources Electric Power Fund**  
**Management's Discussion and Analysis**  
**As of and for the period ended March 31, 2003**

---

Revenue Requirement will be presented for public comment through an administrative process before a final determination is submitted to the CPUC for implementation.

**STATEMENT OF NET ASSETS**

From the date of the revenue bond sale through March 31, 2003, the balances in each of the restricted cash and investment accounts met or exceeded the balance required by the Bond Indenture. All accounts other than the Operating Account had balances that met or exceeded the projected balance in the cash flow analyses utilized in developing the revenue bond structure. The combined balances in the Operating Account and the Priority Contract Account at March 31, 2003 were \$142 million less than projected in the cash flow analyses utilized in developing the revenue bond structure. This was due primarily to a \$40 million transfer in February 2003 to a brokerage account for gas hedging, payments for gas purchases made at above normal prices because of the month long spike in gas prices in February and March 2003, and less than anticipated receipts from one of the IOUs in January 2003. DWR does not believe that the less than projected cash balance in the Operating Account at March 31, 2003 has a significant effect on the Fund's operation. In addition, the March 31, 2003, Operating Account balance is being taken into consideration in establishing the revised minimum Operating Account balance as described in the fourth paragraph of the preceding section.

DWR separately purchases gas as fuel for the production of power under the terms of some of the long-term contracts. DWR maintains a brokerage account with a national brokerage house in order to take positions in futures and options so as to hedge natural gas fuel costs. This account is classified as other investments on the Statements of Net Assets. At June 30, 2002, the account consisted of money market obligations and government bonds valued at \$9.2 million and financial futures and options with a marked to market valuation of \$0.4 million. At March 31, 2003 the account consisted of money market obligations valued at \$20 million and financial futures and options with a marked to market value of \$16 million.

The current portion of recoverable costs reflects billings to IOU customers that have not yet been collected. Long-term recoverable costs consist of costs that are recoverable through future billings. With the resolution of numerous disputes with the IOUs, the current portion of the recoverable costs decreased by \$136 million from June 30, 2002 to March 31, 2002. There was a \$283 million increase in the long-term recoverable costs due principally to the deferral in collection from rate payers of one time costs incurred for issuance of the revenue bonds.

The amount of revenue bonds outstanding at March 31, 2003, reflects the par value of the bonds plus unamortized premium of \$377 million. The first scheduled principal payment for the revenue bonds is May 2004.

Accounts payable at March 31, 2003 and June 30, 2002, both reflect one month's activity for priority contract power purchases. The June 30, 2002 balance also includes accruals for short-term bi-lateral market purchases and ISO markets costs, as these types of costs were incurred by the Fund prior to the January 1, 2003 transition of certain responsibilities to the IOUs.

**Department of Water Resources Electric Power Fund**  
**Management's Discussion and Analysis**  
**As of and for the period ended March 31, 2003**

---

Accrued interest of \$1 million on June 30, 2002 reflects two days accrued interest for the term loan. Accrued interest due to the General Fund at June 30, 2002 is included in the Advances from the State General Fund. Accrued interest of \$158 million at March 31, 2003, represents total interest due on the revenue bonds. The fixed rate bonds provide for semi-annual payments on May 1<sup>st</sup> and November 1<sup>st</sup>, while the variable rate bonds provide for more frequent payments.

## REVENUES

The cost of providing energy is recoverable primarily through Power Charges to the customers of the IOUs. These charges are collected by the IOUs as agent for DWR and forwarded to DWR daily. Charges are determined by applying a CPUC adopted rate for each IOU to the megawatt hours of power delivered by DWR to each IOU's customers. The revenue from Power Charges in the three-month period ended March 31, 2003, was higher compared to the revenues earned during the same period in 2002, due principally to the higher recovery rates adopted by the CPUC effective January 3, 2003.

A separate Bond Charge was established in November 2002, to pay for debt service on the revenue bonds. Bond Charges are determined by applying a CPUC adopted rate to the total megawatt hours of power delivered to the customers in each IOU's service area. Bond Charges earned through March 31, 2003, were \$207 million and are comparable to those forecast in the cash flow analyses utilized in developing the revenue bond structure.

## EXPENDITURES

DWR power purchases were \$295 million less in the nine-month period ended March 31, 2003, than in the same period in 2002. The decrease is due primarily to decreased prices. The average price in the nine-month period ended March 31, 2002, includes the use of short-term contracts, three month or less in duration, that were negotiated prior to the drop in market prices in June 2001, for delivery of power in the high energy consumption months of July through September. Power costs increased \$215 million during the three-month period ended March 31, 2003 as compared to the same period in the prior year. This is attributable to both the spike in market gas prices from mid February through early March 2003 and the payment of annual capacity payments under certain contracts that were not incurred in the prior year. Also included in current year costs is \$12 million in unrealized losses in the brokerage account for gas hedging.

The costs incurred for issuance of revenue bonds for the nine-month period ended March 31, 2003 and 2002, were \$265 million and \$11 million, respectively. The expense for the nine-month period ended March 31, 2003 includes a payments in October and November 2002 totaling \$236 million from bond proceeds for credit enhancement fees, including bond insurance premiums, and underwriters' fees.

**Department of Water Resources Electric Power Fund**  
**Management's Discussion and Analysis**  
**As of and for the period ended March 31, 2003**

---

Interest expense incurred during the both the three-month and nine-month periods ended March 31, 2003 is less than that incurred during the same time periods in 2002. The overall interest rate for the revenue bonds (4.8%) is less than the interest rates incurred in the nine-month period ended March 31, 2002 for both the General Fund advances (5.3%) and the interim loan (5.7%).

#### **FUTURE OF THE FUND**

DWR will administer the Fund until such time as the revenue bonds are completely redeemed. Revenue requirements for the repayment of the bonds will be determined at least annually and submitted to the CPUC. Under the terms of the Rate Agreement between the CPUC and DWR, the CPUC is required to set rates for the customers of the IOUs such that the Fund will always have monies to retire the bonds when due.

DWR has the authority to administer all power supply contracts entered into before December 31, 2002, for the life of the contracts. Revenue requirements for the payment of energy purchased under the long-term contracts will be determined at least annually and submitted to the CPUC. Under the terms of the Rate Agreement between the CPUC and DWR, the CPUC is required to implement Power Charges such that the Fund will receive necessary monies to pay for energy purchased.

As part of its required ongoing monitoring of activities, DWR may determine that a supplemental revenue requirement should be developed and submitted to the CPUC for implementation. As described under the "Transition of Responsibilities Effective January 1, 2003" section, DWR is currently developing a 2003 Supplemental Revenue Requirement.

DWR has been renegotiating a number of the power supply contracts in order to improve reliability, procure more dispatchable power, modify the conditions of assignment of the contracts to the IOUs, and reduce cost. Through March 31, 2003, DWR renegotiated approximately half, in terms of both cost and volume of power, of the long-term contracts that have not otherwise expired. The estimated fixed and variable cost savings through 2015, when the final contract expires, is approximately \$5.5 billion.

Ultimately the financial responsibility for the long-term contracts may be transferred to the IOUs as part of a complete assignment of the contracts and release of DWR. However, there are a number of issues to be addressed, including IOU creditworthiness and counterparty approval, before the contracts can be assigned.



**Department of Water Resources Electric Power Fund**  
**Statements of Net Assets**  
**March 31, 2003 and June 30, 2002**

(in millions)

	Unaudited March 31, 2003	June 30, 2002
<b>Assets</b>		
Current assets:		
Restricted cash and investments:		
Operating Account	\$ 1,197	\$ 2,119
Priority Contract Account	31	-
Bond Charge Collection Account	99	-
Bond Charge Payment Account	308	-
Other investments	36	10
Recoverable costs, current portion	1,182	1,318
Interest receivable	16	32
Due from other funds	-	1
Total current assets	<u>2,869</u>	<u>3,480</u>
Long-term assets:		
Restricted cash and investments:		
Operating Reserve Account	777	-
Debt Service Reserve Account	927	-
Recoverable costs, net of current portion	<u>7,545</u>	<u>7,263</u>
Total long-term assets	<u>9,249</u>	<u>7,263</u>
Total assets	<u>\$ 12,118</u>	<u>\$ 10,743</u>
<b>Capitalization and Liabilities</b>		
Capitalization:		
Long-term debt:		
Revenue bonds	\$ 11,641	\$ -
Advances from State General Fund including accrued interest of \$402	-	6,496
Term loan	-	3,849
Total capitalization	<u>11,641</u>	<u>10,345</u>
Current liabilities:		
Accounts payable	319	397
Accrued interest	<u>158</u>	<u>1</u>
Total current liabilities	<u>477</u>	<u>398</u>
Commitments and Contingencies (Note 5)		
Total capitalization and liabilities	<u>\$ 12,118</u>	<u>\$ 10,743</u>

The accompanying notes are an integral part of these financial statements.

# Department of Water Resources Electric Power Fund

## Statements of Activities

For the three and nine month periods ended March 31, 2003 and 2002

(in millions)

	Unaudited		Unaudited	
	For the 3 months ended		For the 9 months ended	
	March 31, 2003	March 31, 2002	March 31, 2003	March 31, 2002
Revenues:				
Power charges	\$ 1,048	\$ 800	\$ 3,530	\$ 3,342
Bond charges	155	-	207	-
Sales of surplus power	10	7	68	39
Interest income	16	16	46	83
Total revenues	<u>1,229</u>	<u>823</u>	<u>3,851</u>	<u>3,464</u>
Expenses:				
Power purchases	960	745	3,488	3,783
Administrative expenses	15	13	34	35
Costs incurred for issuance of revenue bonds	-	2	256	11
Interest expense	111	156	355	443
Amortization (deferral) of recoverable costs	143	(93)	(282)	(808)
Total expenses	<u>1,229</u>	<u>823</u>	<u>3,851</u>	<u>3,464</u>
Net income	-	-	-	-
Net assets, beginning of period	-	-	-	-
Net assets, end of period	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

The accompanying notes are an integral part of these financial statements.

**Department of Water Resources Electric Power Fund****Statements of Cash Flows****For the nine-month periods ended March 31, 2003 and 2002****(in millions)**

	<b>Unaudited</b>	
	<b>For the 9 months ended</b>	
	<b>March 31, 2003</b>	<b>March 31, 2002</b>
Cash flows from operating activities:		
Receipts from customers:		
Power charges	\$ 3,777	\$ 3,352
Bond charges	186	-
Interest received on investments	62	67
Payments for power purchases (net of sale of surplus power) and other costs	(3,575)	(5,168)
Interest payments	(198)	(188)
Net cash provided by (used in) operating activities	252	(1,937)
Cash flows from non-capital financing activities:		
Proceeds from revenue bonds, net of underwriters' fees and bond insurance premiums	11,437	-
Payments on term loan	(3,849)	(66)
Payments to State of California General Fund	(6,620)	(116)
Net cash provided by (used in) non-capital financing activities	968	(182)
Net increase (decrease) in restricted cash and investments	1,220	(2,119)
Restricted cash and investments, beginning of period	2,119	4,427
Restricted cash and investments, end of period	\$ 3,339	\$ 2,308
Reconciliation of net income to net cash provided by (used in) operating activities:		
Net income	\$ -	\$ -
Changes in net assets and liabilities to reconcile net income to net cash provided by (used in) operations:		
Other Investments	(26)	-
Recoverable costs	(146)	(952)
Interest receivable	16	(23)
Due from other funds	1	7
Advances from State General Fund	124	257
Amortization of revenue bond premium	(20)	-
Costs of issuance paid from revenue bond proceeds	236	-
Accounts payable	(78)	(1,224)
Accrued interest	145	(2)
Total adjustments	252	(1,937)
Net cash provided by (used in) operating activities	\$ 252	\$ (1,937)

The accompanying notes are an integral part of these financial statements.

**Department of Water Resources Electric Power Fund**  
**Notes to Financial Statements**  
**As of and for the period ended March 31, 2003**

---

**1. Reporting Entity**

**Background**

In January 2001, the Governor of California issued an emergency proclamation directing the Department of Water Resources (DWR) to enter into contracts and arrangements for the purchase and sale of electric power to assist in mitigating the effect of a statewide energy supply emergency.

The Department of Water Resources Electric Power Fund (a component unit of the State of California) (Fund) was established on January 19, 2001, by Senate Bill 7 from the First Extraordinary Session of 2001 (SB7X). Assembly Bill 1 from the First Extraordinary Session of 2001 (AB1X), enacted on February 1, 2001, added Division 27 to the California Water Code to clarify and expand the powers of DWR to incur debt for the purposes of the Fund and to use amounts in the Fund for the purchase of power. The Fund is administered by DWR. Division 27 of the California Water Code (as subsequently amended by Senate Bill 31 from the First Extraordinary Session of 2001) includes the following powers and requirements:

- Authorizes DWR to act on behalf of the State of California to secure necessary power supplies for resale to customers of Pacific Gas & Electric Company (PG&E), Southern California Edison Company (SCE), and San Diego Gas & Electric Company (SDG&E) (collectively referred to as the investor owned utilities or IOUs).
- Requires DWR to retain title to all power sold, but authorizes DWR to enter into service agreements with the IOUs for transmission, distribution, billing and collection services.
- Authorizes DWR and the California Public Utilities Commission (CPUC) to enter into an agreement with respect to charges to provide for recovery by DWR of its revenue requirements.
- Authorizes DWR to issue bonds in an amount not to exceed \$13.4 billion and payable solely from the Fund, and to deposit the proceeds of the bonds in the Fund for use for any of the purposes of the Fund.
- Entitles DWR to recover its revenue requirements incurred in connection with its authorized activities, including but not limited to debt service, the costs of power purchases, administrative costs and reserves.
- Restricts DWR from entering into new power purchase agreements after December 31, 2002, but allows DWR to continue to administer existing contracts and enforce revenue requirements beyond that date.

DWR began selling electricity to approximately ten million retail customers in California in January 2001. DWR purchases power from wholesale suppliers under long-term contracts and, through December 31, 2002, in short-term and spot market transactions. DWR power is delivered to the customers through the transmission and distribution systems of the IOUs and payments from the customers are collected for DWR by the IOUs pursuant to servicing arrangements approved and/or ordered by the CPUC.

DWR has financed its power purchases with advances from the General Fund of the State of California, loans from financial institutions, and revenues from power sales to customers. In November 2002, DWR finalized the issuance of \$11.3 billion in revenue bonds. The primary use of

**Department of Water Resources Electric Power Fund**  
**Notes to Financial Statements**  
**As of and for the period ended March 31, 2003**

---

the revenue bond proceeds was to repay the term loan, repay the advances from the General Fund, and establish specific cash and investment accounts as required by the Bond Indenture.

In complying with the restriction to not enter into new power purchase agreements after December 31, 2002, effective January 1, 2003, DWR no longer purchases short-term and spot market power. In addition, DWR transferred the scheduling and settlement functions for the long-term contracts to the IOUs. Ultimately the financial responsibility for the long-term contracts may be transferred to the IOUs as part of a complete assignment of the contracts and release of DWR. However, there are a number of issues to be addressed, including IOU creditworthiness and counterparty approval before the contracts can be assigned.

**Separate Accounts established by the Bond Indenture**

Under the terms of the Bond Indenture separate restricted cash and investment accounts were established. The accounts and their purpose follow:

**Bond Charge Accounts:**

- Bond Charge Collection Account: Bond Charges are deposited into the Bond Charge Collection Account. Monthly, funds needed to make debt service payments or set-asides are transferred to the Bond Charge Payment Account.
- Bond Charge Payment Account: Monies in the Bond Charge Payment Account are used to pay debt service, swap payments and related fees for the revenue bonds. After receipt of the monthly transfer from the Bond Charge Collection Account, the Bond Charge Payment Account must have a balance at least equal to the debt service, swap payments and fees estimated to accrue or be payable for the next succeeding three months.
- Debt Service Reserve Account: The account is to be funded at all times with the amount of maximum aggregate annual debt service on all outstanding debt.

**Power Charge Accounts:**

- Operating Account: Power Charges and miscellaneous revenue are deposited into this account. Monthly, funds are transferred to the Priority Contract Account as needed to make payments on Priority Contracts. Remaining monies are available for payment of all operating costs of the Fund other than Priority Contracts and debt service.
- Priority Contract Account: Monies in the Priority Contract Account are used to make scheduled payments on Priority Contracts. After the monthly transfer from the Operating Account on the fifth of the month, the Priority Contract Account has monies to make scheduled payments on Priority Contracts through the fifth of the following month.
- Operating Reserve Account: The account is to be funded at all times with an amount equal to that derived by formula based on the greater of (i) seven months of projected negative operating cash flows under a stress scenario, or (ii) a specified percentage of projected expenses of the Fund.

**Department of Water Resources Electric Power Fund**  
**Notes to Financial Statements**  
**As of and for the period ended March 31, 2003**

---

**Revenues and Recoverable Costs**

The cost of providing energy is recovered through charges to the customers of IOUs as authorized by AB1X and established by the CPUC. Prior to the issuance of the revenue bonds, costs were recovered through Power Charges. Revenues are now segregated into two categories, Bond Charges and Power Charges. Bond Charges cover all debt service, interest rate swaps and related fees, and Power Charges cover all other costs. Revenues are recognized when energy is delivered to the customers. Costs are recovered over a period of time, as determined by the rate making process between DWR and the CPUC, through the IOUs' billings to the customers.

For the nine-month periods ended March 31, 2003 and 2002, respectively, the Power Charges were reduced by \$117 million and \$221 million, respectively, for rebates given to the customers of the IOUs under the Governor's "20-20 Energy Rebate Program," which, during the summer peak demand months, generally granted the customers a 20% reduction in their monthly power bills if they reduced their energy use by 20% from the same period in 2000. These reductions extend the period of time over which the Fund will recover its costs. There were no rebates given in the three month periods ended March 31, 2003 and 2002.

Amounts that have been earned but not collected are recorded as the current portion of recoverable costs. Costs that are recoverable through future billings are recorded as long-term.

**2. Restricted Cash and Investments**

Restricted cash and investments, for purposes of the statements of cash flows, includes cash on hand and amounts in short-term investments. Amounts in short-term investments consist of deposits in the State of California Pooled Money Investment Account-Surplus Money Investment Fund (SMIF).

Cash not required for current use is invested in SMIF. SMIF has an equity interest in the State of California Pooled Money Investment Account (PMIA). The investments in PMIA are carried at fair value, which approximates amortized cost. Generally, the investments in PMIA are available for withdrawal on demand. Interest on deposits in PMIA varies with the rate of return of the underlying portfolio and approximated 1.98% and 3.42% at March 31, 2003 and June 30, 2002, respectively.

**Department of Water Resources Electric Power Fund**  
**Notes to Financial Statements**  
**As of and for the period ended March 31, 2003**

---

**3. Long-Term Debt**

The following activity occurred in the long-term debt accounts during the nine-month period ending March 31, 2003 (dollars in millions):

	General Fund Advances	Term Loan	Revenue Bonds	Unamor- tized Premium	Total Revenue Bonds	Total Long-term Debt
Balance, June 30, 2002	\$ 6,496	\$ 3,849	\$ -	\$ -	\$ -	\$ 10,345
Accrued interest	124	-	-	-	-	124
Scheduled payments	-	(385)	-	-	-	(385)
Sale of revenue bonds	(6,620)	(3,464)	11,264	397	11,661	1,577
Amortization of premium	-	-	-	(20)	(20)	(20)
Balance, March 31, 2003	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 11,264</u>	<u>\$ 377</u>	<u>\$ 11,641</u>	<u>\$ 11,641</u>

On October 30, 2002, DWR issued \$4.3 billion of tax-exempt variable rate revenue bonds. On November 14, 2002, DWR issued \$6.3 billion in tax-exempt fixed rate revenue bonds and \$.7 billion in taxable fixed rate revenue bonds. The proceeds of the bonds, along with the cash balance in the Fund at the date of issuance, were used to repay previously incurred debt and establish separate accounts in the Fund as required by the Bond Indenture.

The average interest rate for the term loan was 5.7% from June 30, 2002 until the loan was repaid on October 30, 2002. Interest expense on the term loan was \$60 million and \$186 million for the nine-month periods ended March 31, 2003 and 2002, respectively. The average interest rate on the advances from the General Fund approximated 5.31% from June 30, 2002 until the advances were repaid on November 14, 2002. Interest expense on the advances from the General Fund was \$124 million and \$257 million for the nine-month periods ended March 31, 2003 and 2002, respectively.

**Department of Water Resources Electric Power Fund**  
**Notes to Financial Statements**  
**As of and for the period ended March 31, 2003**

---

The revenue bonds consist of the following at March 31, 2003:

Series	Rates	Fiscal Year of Final Maturity	Fiscal Year of First Call Date	Amounts Outstanding (in millions)
A	3 - 6%	2022	2012	\$ 6,314
B	Variable	2020	Callable	1,000
C	Variable	2022	Callable	2,750
D	Variable	2022	Callable	500
E	3.6-4.3%	2006		700
				<u>11,264</u>
Plus:	Unamortized bond premiums			377
				<u>\$ 11,641</u>

The variable rate bonds had a set interest rate of 1.8% through early January 2003, at which time Series B and C converted to daily and weekly rate resets, respectively, and Series D converted to 35-day auction periods. The variable rate bonds have a final stated maturity of 2022, but will be retired in sinking fund installments from 2005 to 2022. Total interest cost through March 31, 2003, for all revenue bonds was \$158 million. The interest rates for the variable debt for the three month period ended March 31, 2003 ranged from 0.75% to 1.80%.

Future payment requirements on the revenue bonds are as follows at March 31, 2003 (dollars in millions):

Fiscal Year	Principal	Interest	Total
2003	\$ -	\$ 218	\$ 218
2004	180	526	706
2005	388	515	903
2006	409	498	907
2007	427	479	906
2008	449	459	908
2009-2013	2,612	1,931	4,543
2014-2018	3,397	1,174	4,571
2019-2022	3,402	296	3,698
	<u>\$ 11,264</u>	<u>\$ 6,096</u>	<u>\$ 17,360</u>



**Department of Water Resources Electric Power Fund**  
**Notes to Financial Statements**  
**As of and for the period ended March 31, 2003**

**4. Interest Rate Swaps**

DWR, on behalf of the Fund, entered into forward interest rate swap agreements with various counterparties wherein DWR has agreed to pay fixed rates of interest and receive floating rate payments approximating the amounts due on a portion of DWR's variable rate debt. The swaps became effective in February 2003. The swap agreements are expected to reduce interest rate risk associated with variable rate bonds issued by DWR. The Fund is potentially exposed to loss in the event the counterparties are unable to perform in accordance with the terms of the agreements. However, DWR does not anticipate nonperformance by the counterparties. The association of the variable rate bonds and terms of the related interest rate swap agreements as of March 31, 2003, are as follows (dollars in millions):

Outstanding Notional Amount	Fixed Rate Paid by Fund	Floating Rate Received by Fund	Termination Date
\$ 94	2.914%	80% of LIBOR through January 1, 2004; 67% LIBOR thereafter	May 1, 2011
234	3.024%	80% of LIBOR through January 1, 2004; 67% LIBOR thereafter	May 1, 2012
330	3.405%	BMA Municipal Swap Index	May 1, 2013
194	3.204%	80% of LIBOR through January 1, 2004; 67% LIBOR thereafter	May 1, 2014
174	3.280%	80% of LIBOR through January 1, 2004; 67% LIBOR thereafter	May 1, 2015
202	3.342%	80% of LIBOR through January 1, 2004; 67% LIBOR thereafter	May 1, 2016
202	3.389%	80% of LIBOR through January 1, 2004; 67% LIBOR thereafter	May 1, 2017
<u>\$ 1,430</u>			

The table below shows the credit ratings, outstanding notional/applicable amount swapped and the number of swaps held by the firms acting as swap counterparties as of March 31, 2003 (dollars in millions):

Swap Counterparty	Moody's	Credit Ratings S&P	Fitch	Outstanding Notional Amount	Number of Swaps
Bank of America	Aa1	AA-	AA	\$ 194	1
Bayerische Landesbank Girozentrale	Aaa	AAA	AAA	502	3
BNP Paribas	Aa2	AA-	AA	202	1
JPMorgan Chase Bank	Aa3	AA-	AA-	200	1
Merrill Lynch Capital Services	Aa3	A+	AA-	30	1
Morgan Stanley Capital Group	Aa3	A+	AA-	302	2
				<u>\$ 1,430</u>	

**Department of Water Resources Electric Power Fund**  
**Notes to Financial Statements**  
**As of and for the period ended March 31, 2003**

---

**5. Commitments and Contingencies**

**Litigation and Uncertainties**

DWR is involved in several lawsuits and regulatory proceedings. In one action, PG&E contested the determination that DWR's revenue requirement submissions to the CPUC for calendar years 2001 and 2002 are just and reasonable. The Court found that DWR had failed to follow the California Administrative Procedures Act (APA) and ordered DWR to do so. The Court also ruled that its decision did not affect any action taken by the CPUC, including the decision establishing DWR Power Charges to recover DWR's 2001 and 2002 revenue requirements. DWR has appealed the decision, but has determined its 2003 and re-determined its 2001-2002 revenue requirements and filed them with the CPUC, after following the procedures set forth in regulations adopted by DWR for the development of its revenue requirements. On October 21, 2002, PG&E filed a lawsuit on the 2003 revenue requirements claiming that DWR had not adequately followed APA requirements. The issues addressed in this lawsuit thus far have been procedural in nature.

In another action, Allegheny Energy Supply Company and its wholly owned subsidiary, Allegheny Trading Finance Company, filed both contract and tort claims before the California Victim Compensation and Government Claims Board (Board) seeking over \$5 billion in damages, after DWR brought a declaratory relief action to terminate Allegheny's long-term contract. The Allegheny claims were rejected by the Board because they raise complex issues of fact and law that should be resolved through formal legal action. The rejection allows Allegheny to initiate litigation. DWR would vigorously defend any such claim should it be brought.

Two energy suppliers have also petitioned the Federal Energy Regulatory Commission (FERC) contending that DWR owes \$58 million for power purchased in the last half of January 2001 on behalf of PG&E and SCE in the California Independent System Operator (ISO) market. DWR maintains that the Fund has remitted the appropriate payments to the ISO for distribution to the energy suppliers. ISO distributed DWR's January payment on a pro-rata basis to all market participants for the entire month even though DWR purchased power on behalf of the two IOUs beginning in late January. As a result, energy suppliers did not receive full payment for the power purchased in January by DWR on behalf of the two IOUs. FERC has not ruled on this matter.

Additionally, various disputes relating the terms and conditions of the power contracts continue to arise and be resolved in the normal course of business.

There are a number of other lawsuits and regulatory proceedings in which DWR is not a party but may be affected by the result because of potential impacts on the price or supply of energy in California. In one case, California Power Exchange Corporation (CalPX), certain IOUs and others have brought suit against the State of California claiming that the State's commandeering of CalPX's block forward contracts after CalPX filed bankruptcy in early 2001 was unconstitutional. The plaintiffs argue that they are entitled to damages of \$1.1 billion, which is their estimation of the fair market value of the block forward contracts at the time of commandeering. Under the block forward contracts, which expired in December 2001, the Fund paid approximately \$350 million for energy provided by the contracts. Additionally, various actions are underway contesting certain long-term power contracts entered into by DWR.

**Department of Water Resources Electric Power Fund**  
**Notes to Financial Statements**  
**As of and for the period ended March 31, 2003**

---

These lawsuits, regulatory proceedings and other uncertainties could affect the revenue requirements and rates needed to pay DWR costs, including debt service, and the terms and conditions of the power purchase contracts.

Management believes that the existing lawsuits, regulatory proceedings and other uncertainties will be resolved in calendar year 2003. The ultimate outcome of these matters cannot be presently determined.

**Self Insurance**

The Fund is self-insured for most risks, including general liability and workers' compensation. Management believes that any costs associated with such losses are recoverable from the customers of the IOUs.

**Commitments**

DWR has entered into long-term power purchase contracts ranging from one to eleven years. Payments made under these contracts approximated \$2.5 billion and \$2.0 billion for the nine month periods ended March 31, 2003 and 2002, respectively. DWR made payments of \$0.8 billion and \$0.6 billion for the three-month periods ended March 31, 2003 and 2002, respectively.

The remaining amounts of fixed obligations under the long-term contracts as of March 31, 2003, are as follows:

<b>For the Year</b>	<b>Fixed</b>
<b>Ending June 30,</b>	<b>Obligation</b>
	<b>(in millions)</b>
2003	\$ 756
2004	3,448
2005	3,234
2006	2,869
2007	2,569
Thereafter	8,313
	<u>\$ 21,189</u>

In addition to the fixed costs there are variable costs with several of the contracts. Management expects that the amount of fixed and variable obligations associated with long-term power purchase contracts to approximate \$30 billion as of March 31, 2003. The difference between the fixed costs and the expected total costs of the contracts are primarily due to the variable factors associated with dispatchable contracts and the cost of natural gas.

DWR has been renegotiating a number of the power supply contracts in order to improve reliability, procure more dispatchable power, modify the conditions of assignment of the contracts to the IOUs, and reduce cost. Through March 31, 2003, DWR has renegotiated approximately half, in terms of both cost and volume of power, of the long-term contracts that have not otherwise expired. The estimated fixed and variable cost savings through 2015, when the final contract expires, is approximately \$5.5 billion.